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SUBJECT: China: PBOC Research Bureau Deputy Director General discusses Chinese economy

SUMMARY

¶1. (SBU) On February 28, Minister Counselor for Financial Affairs and econoff exchanged views on China's macroeconomic and monetary policy with Dr. Jiao Jinpu, Acting Director General of the People's Bank of China (PBOC) Research Bureau. Jiao stressed that, despite the potential deflationary risks of high investment growth and a drop in external demand, he believes the balance of risks in the Chinese economy remain overheating and inflation. As a result, monetary policy will maintain a tightening bias. He believes that high and rising agricultural and commodity prices will keep headline inflation high for the near term, exacerbating already rising inflationary expectations that will lead to wage pressures. Jiao said the PBOC's efforts to constrain the growth of lending will hurt small and medium-sized financial institutions more than large institutions. Jiao expressed concern that expectations of continued RMB appreciation will induce additional capital inflows. Although the rising spread between U.S. and Chinese interest rates could also further induce inflows, Jiao believes capital flows are more sensitive to relative changes in investor expectations about asset prices in China and overseas markets. On renminbi (RMB) appreciation, Jiao reported that gradual appreciation has not had a widespread negative affect on exporters. While a gradual appreciation risks inducing greater inflows than a sudden and large discrete appreciation, the consequences of the latter are less certain, making this a less attractive option to Chinese leaders. End summary.

Balance of risks remain tilted towards inflation

¶2. (SBU) Jiao noted that the Chinese economy is likely to have reached a cyclical peak and could be headed for a period of slower growth. While he noted the potential deflationary risks of continued high investment growth and a drop in external demand, he believes the balance of risks facing monetary authorities remain overheating and inflation. Jiao underscored that some of the recent increase in the inflation rate is due to temporary agricultural supply shocks that are unlikely to be repeated. (Comment: As a result, even if agricultural prices stay high (but don't rise further) this will not necessarily contribute to continued high inflation. End Comment.) However, Jiao expressed concern that high and rising agricultural and commodity prices, due both to global and domestic factors, will keep headline inflation high for the near term, exacerbating already rising inflationary expectations that could lead to wage pressures. These factors increase the risk of keeping inflation high and rising even as the impact of temporary supply shocks wane.

¶3. (SBU) Financial MinCouns pointed out that some economists have argued that China has targeted too low an inflation rate and, like other developing countries with high rates of productivity in the goods sector and a fixed exchange rate, China might be able to tolerate a higher rate of inflation to achieve a real appreciation of its currency to rebalance economic growth, and in particular promote investment in services. Jiao agreed that China could tolerate a slightly higher rate of inflation, but he did not specify what higher threshold would be tolerable, He also stressed that even moderate inflation would have a negative effect on China's economic growth. In Jiao's view, Chinese policy makers must now decide between keeping inflation in check or maintaining rapid short-term economic growth at the expense of longer-term economic stability. "If we seek economic growth without controlling inflation, we will face a long adjustment period in the future," he added.

Monetary policy to retain a tightening bias

¶4. (SBU) Jiao explained that the PBOC plans to maintain a tight monetary policy in reduce inflation. Partly in response to shortages resulting from recent snowstorms, the central government has imposed provisional price controls on specific products. Jiao underscored that the government plans to lift price controls soon, and agreed with Financial MinCouns that price controls would limit incentives to expand production in sectors where prices are controlled.

Monetary policy instruments hurting small and medium financial institutions

¶5. (SBU) According to Jiao, China's large financial institutions have a larger deposit base, and thus more excess liquidity. As a result, they will be less affected by PBOC's policies to reduce the growth of monetary aggregates, such as higher reserve requirements.

The longer the PBOC maintains a tight monetary policy, the more important it is to target policies in a way that forces larger institutions to shoulder more of the burden, Jiao explained.

Capital flows more sensitive to asset prices than interest rate differentials

¶6. (SBU) Jiao expressed concern that expectations of continued RMB appreciation will continue to induce additional capital inflows. In Jiao's view, an extended gradual appreciation of the RMB risks inducing greater inflows than a sudden and large discrete appreciation (Comment: provided it is large enough to convince investors there is two-way risk in the exchange rate's movement. End comment.) However, the economic impact of a large discrete change is less certain, and thus carries greater risks, making it a less attractive option to Chinese leaders. Although the rising spread between U.S. and Chinese interest rates could also further induce inflows, Jiao believes investors' relative expectations about asset prices (in particular real estate) in China and overseas appear to play a more influential role in affecting capital flows than relative interest rates. He explained that foreign investors still view housing prices in Beijing and Shanghai as cheaper than in major U.S. cities, and that investors expect real estate values in China to continue to rise.

Limited adverse impact of renminbi appreciation

¶7. (SBU) Jiao said he believes China should move toward a more market-based exchange rate, but too few participants in the foreign exchange market and capital controls prevent the RMB exchange rate from being freely market-determined. Once these obstacles are removed, he said, we won't need to argue over the exact exchange rate.

¶8. (SBU) Jiao noted that the impact of the RMB's appreciation against the U.S. dollar on exporters has been relatively small. Jiao pointed out, however, that many companies have increasingly complained to PBOC about the RMB's appreciation. In a recent conversation with Huawei's CFO, for example, he learned that Huawei, China's largest networking and telecom equipment supplier, has experienced major losses due to its dollar-denominated transactions and holdings. Financial Mincouns noted that the faster rate of RMB

appreciation and its greater flexibility since last October was both noted and welcome by the USG and encouraged the PBOC to maintain the recent high rate of appreciation.

China should strengthen domestic demand

¶9. (SBU) In Jiao's view, China should strengthen its efforts to expand domestic demand in preparation for a potential downturn in the U.S. economy. Increasing farmers' income and improving financial services in rural areas will play an important role in this effort. Jiao said he expects these issues to be addressed in policy announcements during the National People's Congress, which will convene March 5-18.

Comment

¶10. (SBU) Despite the rising risk that weak external demand and growing productive capacity could be deflationary, Jiao's comments indicate that monetary policy officials continue to believe inflation represents a greater risk, particularly as new central, provincial, and municipal government leaders have traditionally tended to start their terms with large increases in public and publicly-supported investment. Although Jiao stressed the importance of maintaining a tight monetary policy, the monetary policy stance remains less tight than PBOC rhetoric would suggest. In fact, real interest rates remain low (and in some cases negative), broad monetary aggregates continue to exceed nominal GDP, and the RMB has appreciated only modestly on a trade-weighted basis. Jiao's comments that relative expectations on asset price changes are a more important determinant of capital flows than interest rate differentials indicate that despite the Federal Reserve's easing, PBOC officials believe they still have some room to adjust interest rates.